

March 12, 2004
John W. King
Vice President
US Bank
1005 Convention Plaza
St Louis MO 63301

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C., 20551

Re: Comments to proposed amendments to Regulation CC
Docket No: R-1176

This letter is in response to the amendments to Regulation CC published by the Board of Governors of the Federal Reserve System (“Board”) proposing to add a subpart D, with commentary, (“Proposed Rules”) to implement the recently enacted Check Clearing for the 21st Century Act (the “Check 21 Act”). US Bank National Association (“U.S. Bank”) has reviewed the Proposed Rule and has further endorsed and adopted the Comments set forth by certain financial services industry organizations and technology companies (“Industry Commenters”). Because of the importance of recommendations and clarifications sought by the Industry Commenters, US Bank reiterates its support of those comments and further comments as follows:

Comments To Proposed Regulations Under The Check 21 Act

1. MICR Line Issues.

U.S. Bank requests that the Board revise sections 229.2(zz) and 229.51(c) of the Proposed Rules to provide that a substitute check retains its status as the legal equivalent of the original check despite MICR line errors. Industry Commenters have set forth a detailed analysis concerning MICR line issues, and US Bank agrees with the analysis and recommendations of the Industry Commenters.

We strongly agree with Industry Commenters that the legal status of a substitute check should not depend on whether the MICR line is properly read from the original check and printed on the substitute check. So long as the reconverting bank places a MICR line on the substitute check in MICR ink, the substitute check should retain its legal equivalence to the original check regardless of whether the MICR line varies from the MICR line of the original check in the amount field, the routing and transit fields, or in any other field. Should a reconverting bank fail to accurately duplicate the MICR line of the original check to the substitute check, the reconverting bank has violated the Check 21 Act and the regulations which require that the substitute check: (i) bear a MICR line containing all the information appearing on the MICR line of the original check, and (ii) be suitable for automated processing. The reconverting bank would also have violated the encoding warranties under Regulation CC and the UCC which provide that a bank warrants that information encoded after issuance in magnetic ink on the check or returned check is correct. See 12 C.F.R. 229.34(c)(3); UCC Article 4-209.

A collecting bank, paying bank or drawer customer experiencing a direct loss would still be protected by the warranties and indemnities of existing check law . Under this approach, the MICR line of the substitute check could vary from that of the original check without undermining the legal status of the substitute check. This advances one of the stated purposes of the Check 21 Act, “To foster innovation in the check collection system,” as the reconverting bank and all banks in the collection process, would be able to rely on the item as a substitute check.

We further propose that a reconverting bank be allowed to repair a MICR line on a substitute check after creating the substitute check and that such repair should not

affect the legal status of the substitute check or trigger the Check 21 Act warranties. This is consistent with current industry practice, which allows a bank to repair the MICR line of an original check when a bank discovers an error.

For these reasons, US Bank supports the position of the Industry Commenters to include the following in the Commentary to the Proposed Rules:

Section 229.2(zz); Definition of Substitute Check: A reconverting bank shall encode a substitute check in MICR ink with the MICR line information appearing on the original check, except as provided under generally applicable industry standards. A reconverting bank may repair the MICR line of a substitute check after the creation of the substitute check. An inaccurate MICR line on a substitute check as a result of repair or creation does not affect the status of the substitute check as the legal equivalent of the original check.

In addition, we support Industry Commenters' request for clarification and recommendation that a collecting or paying bank may, at its option, repair any portion of a MICR line on a substitute check that it receives for collection without breaching the Check 21 Act warranties. A collecting bank or paying bank that repairs a substitute check in a manner that results in an inaccurate MICR line information (full or partial) would breach the encoding warranties under the UCC and Regulation CC. We agree with the inclusion of the following Commentary to the Proposed Rule.

Section 229.2(zz); Definition of Substitute Check: (##) A bank may repair the MICR line on a substitute check. A repair that alters the MICR line of a substitute check such that it does not accurately represent the MICR line of the original check does not result in a breach of a warranty under the Check 21 Act; although it may result in a breach of the encoding warranties prescribed in the Uniform Commercial Code (Article 4-209) and Section 229.34 of this Regulation (see e.g., the Section 229.34(c) encoding warranties). Repair of a substitute check does not affect the status of the substitute check as the legal equivalent of the original check.

Along with the Industry Commenters, US Bank seeks clarification that the incorrect placement of a required code in position 44 would not affect the legal status of the substitute check or constitute a violation of the Check 21 Act warranties. While US Bank recognizes that a failure to properly encode in position 44 could result in

consequences; any loss associated with such failure could be addressed through clearinghouse rules and/or correspondent bank agreements.

For the reasons stated above, proposes addition of the following Commentary to the Proposed Rule:

Section 229.2(zz); Definition of Substitute Check: (##) A bank that fails to properly encode position 44 on a substitute check, or otherwise fails to comply with the generally applicable industry standards for encoding a MICR line on a substitute check, does not breach the warranty under Section 5 of the Act; although it may breach the Section 3(16) requirement of the Act that the substitute check conform to generally applicable industry standards. Failure to encode position 44 in compliance with the generally applicable industry standards does not affect the status of the substitute check as the legal equivalent of the original check.

2. Purported Substitute Checks

U.S. Bank requests that the Board delete section 229.51(c) of the Proposed Rule. Proposed Section 229.51(c) provides that a bank which transfers and receives consideration for an item that meets all the requirements of a substitute check except for the MICR line requirement, that item is a substitute check for the expedited recredit, indemnity and warranty provisions of the regulation. Such an item does not meet the definition of substitute check. We can decipher no reason why an item that otherwise meets the requirements of a substitute check should lose its legal status because of an incorrect MICR encoding. A substitute check should retain its legal equivalency, notwithstanding incorrect or altered MICR line information. Doing so would help to ensure a reliable new system of substitute check presentment.

While we understand the Board's concern that reconverting banks ensure that they accurately reproduce original checks when creating substitute checks, we think the industry consequences can meet this objective. For example, a reconverting bank that inaccurately reproduces an original check may experience collection delays as paying banks struggle to handle the item. At the same time, some paying banks may be able to understand whether a substitute check is properly payable upon receipt. Under the proposal, however, the paying bank would have to return the item to the reconverting bank for correction, thereby delaying payment. A better approach is to allow the industry to monitor itself with respect to purported substitute checks. Provided the only flaw of a

substitute check is the MICR encoding, we think the Board should consider such an item a substitute check.

Like other industry commenters, we also urge the Board to include a provision that authorizes a paying bank to create a legally equivalent substitute check without the requirement of printing MICR line in MICR ink on the check. However, to prevent the inclusion of check copies and images within the scope of the Act, we agree that such non-MICR substitute checks should meet all other requirements under the Act, including that the item include the appropriate legend. Customers who receive substitute checks that have been paid and canceled by the paying bank do not need a substitute check that contains a MICR line printed in ink. In addition, the creation of such a document would expose banks to lower costs, urging more banks to embrace check truncation. For these reasons, we support the addition of the following Rule:

“Exemption From Requirement to MICR Ink Encode Substitute Checks: A paying bank may at its option print the MICR line information from the original check on a substitute check with non-MICR ink, and such substitute check does not otherwise need to be suitable for automated processing in the same manner as the original check, provided: (i) the check has been paid by the bank and will not be further processed on an automated basis through the forward or return bank check collection process, (ii) the paying bank is delivering the substitute check to its own customer; (iii) the information from the MICR line on the original check is printed in non-MICR ink and in MICR font on the substitute check in the same location as on the original check; and (iv) the paying bank otherwise complies with the requirements for substitute checks under the Act. In this situation, this substitute check without MICR ink would be deemed to satisfy the requirements of a “substitute check” for all purposes under the Act and this regulation.”

3. Treatment of Generally Applicable Industry Standards

We agree with Industry Commenters and recommend that the Board clarify in the final rule that the generally applicable industry standards that are identified in the Commentary are an exclusive list subject to amendment by the Board or a standards committee and support the inclusion of the following in the final rule:

Generally Applicable Industry Standards. The Specification for an Image Replacement Document – IRD’ issued by the Accredited Standards Committee (ASC) X9, Inc., shall constitute the exclusive generally applicable industry standard for substitute checks. These standards may be amended and revised

from time to time by the Accredited Standards Committee (ASC) X9, Inc., or its successor.

4. Application of Section 5 Warranty to ACH and Electronic Funds Transfers

We agree with the position of Industry Commenters that the Section 5(2) warranty of the Act should not apply to a second debit that is created with information from the original check or a substitute check and delivered via the ACH network. We support inclusion of the following in the Commentary to the Proposed Rule:

Section 229.52(a)(2). A reconverting bank that has presented a substitute check to a paying bank would not be in breach of the warranty under Section 229.52(a)(2) and Section 5(2) of the Act in the event that an electronic fund transfer, such as an ACH debit, is subsequently initiated using information obtained from the original check or the substitute check relating to that original check. An electronic funds transfer does not result in a “payment based on a check” that would cause a breach of this warranty. The customer whose account was inappropriately debited for this electronic fund transfer would have the protection provided under electronic fund transfer law.

5. Delivery of Notice at Time of Consumer Request for Copy of Check

We support delivery of the notice at the time the financial institution provides the substitute check. We agree that the final rule should allow the financial institution to provide the notice to the consumer at any time after the initial request up to and including the time the substitute check is delivered to the consumer.

We support the inclusion of the following commentary

Suggested Regulatory Text:

“Section 229.57(b)(2) . . . (i) Requests an original check or a copy of a check and receives a substitute check by or at the time the bank provides such substitute check.”

6. Model Consumer Educational Document

We agree with the position of the Industry Commenters and we reiterate the necessity that the final regulation provide assurances to financial institutions that use of the Model Notices set forth in the Appendix constitutes compliance with the Act.

7. Breach of UCC Warranties As Precondition To Expedited Recredit

The Board has included in Commentary to Section 229.54(a)(2) of the Proposed Rules a provision allowing consumers to make expedited recredit claims for a breach of UCC warranties with respect to a substitute check. We do not believe that the Board's position is supported by the Act.

The purpose of the Check 21 Act was to authorize the creation and use of substitute checks, and in certain cases provide receivers of substitute checks with additional protections. The Act was not intended to alter the manner in which current check law applies to a substitute check or the manner in which banks resolve disputes with their customers under current check law. For this reason, we support the position of the Industry Commenters that expedited recredit should be limited to substitute check warranty claims as set forth in the Check 21 Act.

Respectfully Submitted,

John W. King
Vice President
US Bank